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In the Supreme Court of the United States

OCTOBER TERM, 1980

WILLIAM J. O'HARE AND PATRICIA E. O'HARE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The principal question in this federal income tax case is whether the decision below correctly held that $40,000 petitioner[1] earned in a transaction by which a parcel of realty was acquired from the original owner and subsequently resold to a third-party purchaser was a financer's fee taxable as ordinary income and not as gain from the sale of a capital asset taxable at capital gains rates.

The pertinent facts may be summarized as follows (Pet. App. A-2 to A-4; B-4 to B-8): Petitioner was the attorney for IX Investors, a corporation engaged in the purchase and sale of real property. In 1973, Investors entered into a contract for the acquisition of a parcel of realty known as Ferry Farm for $248,000, and made a $24,800 down payment pursuant to the contract. Subsequently, however,

[1]References to "petitioner" are to William J. O'Hare. His wife, Patricia E. O'Hare, is a party to this case solely because she filed a joint tax return for the year at issue.

Investors became unable to arrange for the required financing to complete the purchase. After Investors unsuccessfully offered to pay up to $70,000 to anyone who could arrange the necessary financing, a Federal Land Bank office indicated its willingness to make the loan provided an individual of adequate net worth would guarantee the obligation. Petitioner thereafter agreed to guarantee the corporation's obligation in this respect and submitted his financial statement to the Bank. Although petitioner's financial statement apparently satisfied the Bank, it further requested petitioner to take title to the property (Ferry Farm) in his own name and to serve as the nominal mortgagor and borrower. Accordingly, petitioner entered into an agreement with Investors under which the latter assigned its purchase contract to petitioner and which contained the following additional provisions:

1. Petitioner would borrow $200,000 from the Bank and acquire and hold Ferry Farm in his own name while a purchaser was sought;

2. Investors would pay the balance of the down payment and all other expenses of acquiring the property, other than the $200,000 loan proceeds;[2]

3. Petitioner would not encumber the property (other than as security for the $200,000 loan) without the consent of Investors;

4. When a resale was consummated, the loan from the Bank would be repaid and petitioner was to receive a payment, without regard to the resale price, which would

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[2]While the agreement did not expressly so provide, the Tax Court found (Pet. App. B-7) that Investors would pay all expenses in connection with the holding and ultimate resale of the property. In fact, Investors actually paid such expenses (Pet. App. B-8).

depend upon the length of time it took to effect the resale. (This payment was not contingent upon the realization of profit on the resale.)

Investors thereafter found a purchaser and Ferry Farm was conveyed to that third party in August 1974, for $335,000. Because the holding period was more than four, but less than eight months, petitioner was entitled to a payment of $50,000.[3] However, in order to accommodate Investor's purpose to realize an acceptable profit, petitioner agreed to accept $40,000 (Pet. App. A-5; B-8 to B-9).

Petitioner sought to treat the $40,000 as capital gain on the theory that he was a joint venturer with Investors in the acquisition, holding and resale of the property. Both courts below agreed with the Commissioner's determination that petitioner was simply a provider of financing for a fee and that the $40,000 was therefore ordinary income (Pet. Apps. A & B).

1. Petitioner acknowledges the force of the "substance over form" rule which formed the basis of the decision below that the $40,000 he earned on the transaction was not gain from the sale of Ferry Farm. He nevertheless argues (Pet. 14-23) that he must be regarded as a joint venturer with Investors and thus a holder of Ferry Farm for resale at a profit because, under New York law, his holding of the title to the property placed upon him certain risks such as tort liability, liability for property taxes, etc., and put him in the position where only he could convey title, create a

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[3]Under the agreement, petitioner was to receive $25,000 if the resale and liquidation of the bank loan took less than four months; $50,000 if the time was from four to eight months; and $75,000 if it was more than eight months (Pet. App. B-6 to B-7).

mortgage interest, etc.[4] He complains that the court of appeals erred in ignoring these legal consequences under state law.

But the court did not ignore petitioner's theoretical rights and obligations under state law. Rather, it took note (Pet. App. A-7) of the state law relied on by petitioner but concluded that it "did not convert O'Hare into a joint venturer." As this Court stated long ago in *Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932), "[t]he state law creates legal interests but the federal statute determines when and how they shall be taxed." Accord: *Comtel* v. *Commissioner*, 376 F. 2d 791 (2d Cir.), cert. denied, 389 U.S. 929 (1967).

As the court of appeals correctly pointed out, the reward to which petitioner looked in entering the transaction was not that of an investor or co-venturer but of a provider of financing or credit. No matter how much the property appreciated during the holding period, petitioner was limited to his fixed return which was geared to the length of the period during which his credit remained at risk. Conversely, he was entitled to that payment even if the property was ultimately sold at a loss. Petitioner could not encumber or dispose of the property without Investors' approval and, as far as the record reveals, had no power to veto a sale, or sales price, arranged by Investors.[5] In these circumstances,

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[4]These latter powers, of course, constituted the form of the transaction. Under the substance of the arrangement, petitioner could do these things only to the extent permitted by Investors.

[5]Petitioner states (Pet. 11) that both he and Investors made efforts to locate a purchaser for Ferry Farm. But the record contains no indication of any effort on petitioner's part in this respect or that he did anything other than passively await a resale arrangement by Investors and instructions as to where and when to convey the legal title.

petitioner's mere holding of title to Ferry Farm did not make him the owner of that property.[6]

2. Finally, petitioner argues (Pet. 29-36) that the decision below conflicts with *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). But the finder of fact reached a wholly different conclusion in that case. There, the district court found that the parties intended to create a bona fide sale-and-leaseback (435 U.S. at 569). Here, on the other hand, the Tax Court found (Pet. App. B-11) that "[p]etitioner never had any intention of buying the property in his own right * * *." In *Frank Lyon*, taxpayer contended that it had the right to sell the property at any time (435 U.S. at 570 n.5) and there was no finding to the contrary. Here, petitioner was not even permitted to encumber the property, much less sell it, without Investors' approval. Moreover, unlike *Frank Lyon* where the taxpayer would have realized any appreciated value on the sale of the property, petitioner was limited to its fixed fee schedule and had no right to realize any value appreciation (nor would it suffer any loss on resale from depreciation in value). Finally, in *Frank Lyon*, each of the parties paid the expenses and received the rewards usually assigned to their respective roles in the transaction. Here, Investors—and not petitioner—paid all

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[6]Contrary to petitioner's further assertion (Pet. 24-29), the decision below does not conflict with *Murry* v. *Commissioner*, 601 F. 2d 892 (5th Cir. 1979). *Murry* did not involve a comparable transaction. Moreover, the other Fifth Circuit cases cited by petitioner only stand for the general principle that state law will be considered in determining legal rights and consequences among the parties but not in fixing federal tax treatment. The decision below did not question that principle but properly concluded that petitioner's theoretical obligation under New York law could not, on balance, outweigh the compelling fact that petitioner did not, for the most part, have the usual rights of an owner-holder so that the amount received by him was obviously intended by the parties as a reward for financing services.

the expenses associated with the purchase, holding and resale of the property. Accordingly, the decision below is not inconsistent with the result in *Frank Lyon.*

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General

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